Behavioural Theory of the Firm

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Definition

Behavioural theory of the firm (BTF) is a composition of a number of theories that have emerged within economics, sociology, business and management studies – to deal with the issues of how firms behave in a market place and what determines the inter-firm relationships.

Conceptual overview

The economic theory of the firm looks at the firm as a black box, as a unit processing inputs into outputs. The behavioural theory of the firm (BTF) attempt to compensate for this narrow view, and looks at what happens inside the firm, how the throughput takes place as economic activity, and how decisions are made regarding production, scheduling, and inventory. The BTF is known also as a decision theory, as it explains the circumstances of operational decisions, and the outcomes that contribute to value added. Decisions are interpreted as a sequential process which includes both rational and non-rational aspects, and are affected by ownership rights, liabilities, control over resources, and power.

Other core concepts related to the BTF are the notion of firm's competences and capabilities, organisational learning, accumulation of knowledge, cognition and motivation, or how firms learn about their internal and external environment. The BTF advocates for the endogeneity of preferences and expectation as the main source of bounded rationality, or the 'irrational' choices made by firm's managers in situations of uncertainty and complexity.

The BTF is a complex agglomeration of business and management theories that contribute to our understanding of the firm. Since its inception, the BTF is dealing with the question of firm boundaries and the related questions of incentives within and outside these boundaries, or opportunities in the environment to capture value and to generate profits and rents. Ultimately the BTF explains strategic decision making beyond environmental incentives. It is also related to the foundations of the institutional and evolutionary theory of the firm and to various learning and innovation theories.

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[1] In: International Encyclopedia of Organization Studies, 2007, Sage.

Critical commentary and future directions

The nature and behaviour of firms have been elaborated in a large number of economic, strategy, and management theories that contribute to BTF. Economic theories treat firms as autonomous actors that are engaged in value creation activities, utilising various resource inputs and factors of production, where firm behaviour is induced by environmental incentives and constraints. The strategic management theory has recognised that behind each firm stands a management team, composed of professionals that are empowered to make decisions regarding strategic alternatives, regarding internal allocation of resources, or giving direction to firm's activities. Strategic behaviour of the firm in this context is represented by the strategic choices of managers. Administration and management theories also have contributed to the debate on decision making, power relationships, and structure – or factors that induce firms' behavioural responses. Sociological, anthropological and organisational behaviour theories have explored the behaviour of individuals, groups, institutions and other organised entities, as well as the development and interaction with technologies and socio-cultural artefacts.

Different theories refer to different definitions of the firm. Whitley defines firms as centres of economic power that combine *allocative decision making* with *authoritative coordination* of economic activities and as such they add value to human and material resources through collective organisation of work. Firms are seen as dominant units of strategic decision making and planned coordination that combine *differentiated skills, capabilities and knowledge,* and embody a *collective organisation* which transforms human and material resources into productive services. Attributes of these economic actors are: *governance structure*; *separation of ownership from control*, and *delegation of control*; *goals and objectives* realised within particular profit constraints; diversity of *activities and capabilities* which are coordinated through *authoritative communication*; and radical *discontinuities* in the carried out activities and capabilities.

Mark Casson gives another original definition of the firm – as an *institution that specialises in coordination of business functions using a single locus of responsibility as a legal entity, and a structure designed to harmonise the decision making efforts of a group of people*. The attributes of the firm in Casson's framework can be described as specific roles and functions and include the following: the firm as *producer* (transforming inputs into outputs); as *organiser* (making price and production decisions in the context of permanent market volatility); as *employer* (contracting resources, engaged in and designing the division of labour); as *intermediator* (possessing simultaneously special knowledge of valuations of goods and market information on possibilities for the market relocation of these goods for alternative use); as *risk-taking vs. risk-aversive* decision maker; as *user of information* (capable of acquiring trade-related information as the basis for long-run comparative advantage); and as *evaluator* (capable of evaluation of resources and self-evaluation of competencies).

Organisation theories also have left a footprint in the definitional maze, conceptualising firms as organised collectivities - *goal-directed, resource dependent, boundary maintaining, and socially constructed system of human activity, comprising of deliberate design, status structures, orientation towards an environment, with shared understanding among participants, and substitutability of personnel who is entitled to various organisational benefits*.

As goal directed, firms generate preferences and choices for their members, and are vulnerable to be controlled by owners and leaders through the preferences of these leaders. As resource dependent, organisations seek, acquire, and accumulate tangible and intangible resources, capabilities and competences that enable them to accomplish the work. As boundary-maintaining, organisations enlist membership and draw a distinction between members and non-members. Organisations also develop membership rules and procedures to coordinate and manage the membership status of actors. As an activity system, each organisation consists of interdependent role behaviours, set of routines, and a bundle or multiple sequences of activities accomplishing the work. The activity system is represented by what organisations do and what organisational members enact in the process of participating. Overall social scientists would agree that firms are simultaneously a bundle of contracts, a bundle of resources, and a bundle of knowledge and information.

Among the leading economic theories that have contributed to our understanding of firm behaviour are: transaction cost economics, non-cooperative game theory, agency theory, and contract theory. The two building blocks for the economists have been ‘incentives’ and ‘costs’, and hence the development of theories that explain sources of incentives (property rights, governance theories, and agency theories), and sources of costs (contract theory, transaction cost economics, and various shareholder theories of cooperation).

Transaction-cost theory has developed the argument that firm behaviour is driven by rational choices based on cost calculations. Scientists using transaction cost economics usually study strategic responses by firms that lead to specialisation and diversification, or decisions related to cost control and activities within the boundaries of the firm.

The *non-co-operative game theory* is a representative of the 'incentives' school in economics and analyses the underlying motives of strategic behaviour in a competitive environment under the conditions of limited access to information. According to the leading theorists in this field, the market players aim to maximise their payoffs in a wider sense, rather than maximising profits. The market behaviour of each actor is determined by the market structure that provides different incentives for actors. Usually alternative strategic choices utilised by players are to cooperate or to compete. The behavioural adjustments that players make in the process of interaction are according to their expectations, observations of others' motives, and rational calculations of their own self-interest.

Agency theory brings more insights into the formal and informal contracts that facilitate exchanges between firms and the bargaining and negotiation of these contracts. The agency theory of the firm, looks at the company as governed by a set of contractual relationships, or a bundle of contracts. The firm is only a legal entity, an agent engaged in bi-lateral and multi-lateral contracts. The agency theory does not look at the contracts themselves, but what decision-making power they constitute and what relationships they represent. Each contract is conceptualised as a formal agreement between a principle (delegating power), and an agent (exercising this power and making decisions on behalf of the principle).

The theory also reveals the political nature of firms, involved in continuous negotiations of contracts. The bargaining and political nature of these contracts suggests that the relationships behind these contracts are a balance of competition and co-operation between actors, and behaviour is induced by a set of motives and incentives, embedded in agreed contracts.

The *contract theory* is related to the 'new institutional economics' and has adopted a critical stand to assumptions about contracts. All contracts are inherently dependent on the institutional form of intermediation that exists for contract enforcement, on the ability of contracting agents to acquire and synthesise all relevant information, and on the environmental volatility.

In addition to formal contracts there are relational contracts that rely on a range of diverse coordination mechanisms such as 'reciprocity norms', 'inter-organizational trust', and 'social capital' - embedded in multiplex of exchanges and social interactions. As a theoretical perspective, the scientific assumptions of mutuality and agreement that implicitly underlay relational contracting contrasts with the opportunism which is explicitly presumed in both agency theory and transaction cost economics.

Relational contracting embraces not only unspecifiable terms and conditions in complex and open-ended contracts, but also collective inter-organizational strategies employing tacit coordination. Pursuing a collective strategy typically depends on unanticipated future conditions that cannot be explicitly written into formal contractual agreements between business partners. Hence, successful strategies require basic trust, mutual understanding, unrestricted learning, and inter-organizational knowledge-sharing to achieve a high level of joint decision making at both strategic and operational levels. Doz, Olk and Ring have operationalised these processes as 'open solicitation' and 'seeking domain consensus', where the relational partners continually elaborate on their mutual objectives, capabilities, resources, and tasks. Achieving a consensus would then serve as a foundation on which relationally contracted firms could subsequently announce and implement formal contracts. A central issue in relational contracting remains how best to manage the balance between interdependence and control.

Managerial theory of the firm (MTF) is related to both agency theory and contract theory. It had also accommodated contributions from institutional theory, contingency theory, population ecology, and strategic management theory, and particularly the resource-based view and the knowledge-based view of the firm. In its entire complexity it puts emphasis on the variety of competencies, specialised resources and assets that each firm has in principle and the tendency of the firm on one hand to match its structure and processes to the changes in the environment, and on the other - to develop a unique character in order to acquire strategic competitive advantage.

The foundations of the MTF are built on the recognition that the separation of ownership from control transfers the control power from the owners to the managers. This separation gives power to managers who do not carry liabilities, and as consequence gives rise to the bureaucratic power that emerge in the efforts to manage organisational resources.

Much of the development of the MTF is based on the fundamental assumption by Cyert and March of the maximising behaviour of actors, where participants receive inducements from the organisation in return for their contributions and they aim to maximise these inducements. This assumption is extended in the literature with the argument that decision making in organisations is rational and goal oriented. Hence, managerial decisions are aiming at maximising both personal and organisational outcomes.

Goals are derived at in the process of bargaining between individual participants within the firm. In this process of bargaining and negotiations of goals participants develop expectations regarding the behaviour of the others, and may adjust their own goals according to the expectations of others. The goal adaptation process frames different strategic opportunities and modifies alternative organisational choices of actors within firms. Organisational choices are defined as outcomes from the goal adaptation and the decision-making process. On these grounds some authors reject the assumption of the profit-maximisation of the firm as an overall orientation in the market place, and suggest that decision-making and negotiations lead to optimising behaviour.

Overall, the MTF has produced a number of conceptual frameworks that explain the use of power to control the behaviour of other actors, and the use of various relationships and manipulative techniques to counteract uncertainties and opposition, or to coordinate the activities and behaviour of others. Among the tools and means to control the behaviour of actors that are explored, are the use of incentives, power and coalitions. The coalitions (or cliques) built by managers usually aim to ensure that all participants share similar objectives and are willing to compromise and to give support to each other in everyday decision making. Overall the managerial theory of the firm treats in equal way the behaviour of the firm and the strategic choices of the managers - even though the later is a means of the former.

Other established organisation and management theories that have advanced our knowledge are: resource dependence theory; knowledge-based view; contingency theory; population-ecology; institutional theory. The main building blocks in management science have been: resources and capabilities, environmental factors, and strategic response.

According to the *resource-based view*, the accumulation of heterogeneous resources is a selective and strategic process that originates with a managerial vision as a significant driving force. It is difficult to establish the causality between accumulated resources and assets by a firm and specific strategic decisions - both are simultaneously constraints and opportunities for each other. Academic writers emphasise that firm's opportunity set is unique which follows from the unique bundle of resources possessed by each firm. Strategic decisions lead to both accumulation of unique resources and designing unique trajectories for firm's growth and development.

Strategic decisions with resource implications include those of asset ownership, the use of technologies, the structuring of activities, the scope of internalisation, diversification of products, or new market entry – amongst others.

The *knowledge-based view of the firm* looks at firms as acting bundles of knowledge and skills embedded in organisational routines and practices. The knowledge is not treated merely as a resource, but as an essential element of the learning process that takes part in parallel with the work process. This learning framework challenges all established economic theories suggesting that the value of assets changes in congruence with the voluntary contributions by learning agents that chose to produce added value above the contracted one. It is acknowledged also that learning takes place across the boundaries of the firm, which makes the value added process in firms subject to relationships and information flows beyond the control of the management. Informal or incomplete contracts are suggested to give learning advantages to actors, allowing them to extend their capacity and capabilities during the process of carrying out the contracted activity, and hence generating extended value for their input.

Firms' abilities to learn are also referred to as dynamic capabilities, allowing these agents to gain comparative advantage. Essential pre-condition for learning is a shared context of language and culture that allows actors to communicate, interact, exchange information and relate to each other, strengthening further the initial framework of shared understanding.

Contingency theory is one of the predecessors of the knowledge-based view and has argued about the same dynamic adaptation between an organisation and its environment. Changes both in the internal and the external environment generate adaptive responses with subsequent re-location of resources and learning.

The development of *evolutionary theory* has focused on the fundamental processes of variation, selection and retention in populations of firms. These processes emerge as a result of the cumulative effect from behavioural choices of all firms in a population. The variation principle suggests that firms vary in the routines they have developed to conduct their business. As these routines capture tacit knowledge and endogenous learning, they capture unique bundles of firm-specific resources and capabilities. The second principle of selection refers to some behavioural choices and routines being revealed to be more effective then others, and therefore becoming dominant over time through natural selection by the market. The principle of selection by the market assumes that certain routines lead to improved market performance. The retention principle refers to firm's capabilities to manage their bundle of resources and practices while competing with other firms. Retention hence means not absolute superior knowledge, capabilities, and behavioural choices, but relative advantage of these.

Overall the evolutionary theory in sociology and economics brings a Darwinian perspective to the analysis of firm behaviour, and puts emphasis on the dynamic aspects of this behaviour through change, adaptation, development and growth over time. It puts the environment as an endogenous factor that justifies the variation in organisational forms and in governance types. The theory also substantiates the argument for heterogeneity in actors' forms and attributes. As a theory, it offers explanations of the boundaries of organisations and populations which demarcate an entity from its environment. It also offers theoretical explanation for behavioural choices that lead to firm's mimicry, inertia, and survival.

The *institutional theory* is primarily concerned with the relationship or the fit between organizations and their institutional environment, and the normative context of this environment encapsulated in cultural, institutional and social conventions. Behaviour is analysed from the perspective of the effects of social expectations (norms) on the actors, and the extent to which actors comply with these norms, and conform with the established rules and institutional practices.

Theorists put emphasis on the coercive, mimetic, or normative isomorphism among business organisations. The sources of this isomorphism are various environmental pressures. Examples of behaviour that results from environmental pressures are when firms react to stakeholder's expectations in an attempt to carry social responsibilities, or when firms copy each-other and produce the so-called ‘band-wagon’ effect where multiple firms make similar choices and follow market leaders. Often these behavioural responses aim to enhance the legitimation of a firm.

The BTF represents a diverse pool of theorising about behaviour in economic context. In its entire complexity it does not offer significant chances for integration, but the efforts in this direction continue.

Cross-references: Agency, Complexity of decision making, contingency theory, evolutionary theory, game theory, institutional theory, principle-agent theory, rational choice theory, transaction cost theory

References and Further Reading

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